

AIR TRANSPORT ASSOCIATION OF AMERICA, INC.

**STATEMENT FOR THE RECORD OF THE
SUBCOMMITTEE ON AVIATION
TRANSPORTATION AND INFRASTRUCTURE
COMMITTEE
U.S. HOUSE OF REPRESENTATIVES**

**CONCERNING
THE FINANCIAL CONDITION OF THE U.S. AIRLINE
INDUSTRY**

JUNE 3, 2004

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INTRODUCTION

The Air Transport Association of America, Inc. (ATA) greatly appreciates the opportunity to share with the Subcommittee the facts concerning the financial condition of the U.S. airline industry.

The economic health of the U.S. airline industry remains tenuous, in spite of passenger traffic volumes returning to pre-9/11 levels. At the beginning of this year, the industry held out hope for a return to some degree of stability, if not profitability. Yet new costs beyond the airlines' control wiped out recent efforts to cut costs and achieve new efficiencies. Record high oil prices and the nation's ongoing war on terrorism, including sustained uncertainty in Iraq, have presented new barriers to improving the industry's financial health.

In spite of suffering through the three most difficult years in the history of the airline industry, and with a near-term turn around unlikely, the Administration and Congress are considering further increasing the industry's tax burden and ending a post-9/11 program that has been essential to the continued operation of the domestic airline industry.

The Aviation Security Infrastructure Fee (ASIF) - The Administration has proposed, and some in Congress are supporting, a 138 percent increase in the taxes that airlines pay under the ASIF program. The airlines, their employees and other impacted groups strongly oppose this tax increase.

Expiration of the Federal War-Risk Insurance Program – The statute that directs the Federal Aviation Administration (FAA) to extend war-risk insurance to U.S. airlines and air cargo carriers is set to expire on August 31 of this year. Air carriers are required to have war-risk coverage, but no reliable and competitive commercial market exists for this insurance. Without a federal program to cover U.S. carriers, the industry could obtain coverage of only limited utility that would several hundred millions of dollars in new insurance costs annually. Congress must extend the federal war-risk insurance program and related terrorism liability cap.

Continuing growth in federally mandated security requirements, taxes and fees – Air carriers are now shouldering an estimated \$3.8 billion per year in costs/taxes/fees related to security, in spite of a federal recognition that the security of our nation's aviation system is the responsibility of the Federal government. Terrorists did not seek to harm two airlines on 9/11, they sought to do harm to our nation. Congress and the Administration must act on the recognition that protecting the airline industry, like any other segment of our population or economy, is a federal responsibility and fund it accordingly.¹

¹ 'The conferees recognize that the safety and security of the civil air transportation system is critical to the security of the United States and its national defense, and that a safe and secure United States civil air transportation system is essential to the basic freedom of America to move in intrastate, interstate and international air transportation. The conferees further note the terrorist hijacking and crashes of passenger aircraft on September 11, 2001, which converted civil aircraft into guided bombs for strikes against the United States, required a fundamental change in the way it approaches the task of ensuring the safety and

* * *

As we enter the summer season of Year Three of the post-9/11 era, this hearing is extremely timely. As noted, this is the time when we *expected* to be able to confirm predictions about the industry's return to some measure of stability and to discuss the prospects for growth and future earnings. Instead, the industry remains mired in red ink with only the faintest and dissipating hope that 2005 may be the year when the U.S. airline industry finally turns the corner.

- From 2001 through 2003, U.S. airlines lost \$23.2 billion.
- In 2004, we now expect the industry to post a net loss in excess of \$3 billion.

The financial condition of the U.S. airline industry over the past three years has been shaped by circumstances both within and beyond the control of the airlines. To the extent these circumstances were within the control of the carriers, they have been confronted aggressively and, in major respects, corrected. Unfortunately, with regard to external circumstances, including a large number of government policy decisions, the situation has worsened.

The continued impact of these circumstances on the airlines has been catastrophic, both individually and collectively. The 9/11 terrorist attacks, SARS, the war in Iraq and continuing occupation, the unabated threat of new acts of terrorism coupled with the ongoing national war on terrorism and, most recently, the unrelenting upward spiral of fuel prices, all have had a dramatic impact on the industry and have contributed to the unacceptable financial condition that the industry is in today.

security of the civil air transportation system.” Conference Report - Aviation and Transportation Security Act, H.R. Report 107-296, at 53 (November 16, 2001).

The airlines have responded vigorously to matters within their control. Indeed, the carriers began taking steps to respond to the downturn in demand and their cost structure issues before the horrific events of 9/11 and the exacerbating factors that followed. They have taken, and are continuing to expand, measures to contain costs and improve efficiency. These actions have been painful for employees, management, vendors and third-party suppliers, airports, travel agents and shareholders. But the airline industry has refused to adopt a “victim” perspective. The ATA members and other airlines continue to adjust to the new market paradigm, finding new and better ways to do business.

Through all of these events and changes, we have learned several lessons that bear repeating here:

- **Aviation security is National Security.** As with any other national security function, it must be funded out of general tax revenues or risk the further destabilization of a core element of our nation’s economy.
- **The U.S. economy depends on a strong airline industry.** Government policies should support stability and growth, and permit airlines to attract needed capital, especially now. These criteria should be the principal drivers of policy choices.
- **The airline industry remains heavily regulated in major respects.** In order to accommodate rapidly evolving economic conditions, agencies must be disciplined in exercising their regulatory authority.
- **Threats to security and safety must be prioritized** based on a careful review of the facts, and solutions must provide a clear and justifiable

benefit – both on their own merits and relative to other known risks. The Government must resist the temptation to succumb to the “not on my watch” rationale as the basis for imposing new regulatory mandates without regard to their relative merit in relation to existing resources or their operational impact.

- **The U.S. airline industry remains incredibly safe**, notwithstanding the challenges of the past three years. In these hard times, the professionalism of the airline industry – especially its rank and file workers – as well as that of the FAA, continues to drive the industry forward despite unprecedented adversity.
- **The U.S. Economy Depends Upon Multiple Air Service Models.** It has become popular to argue that the “legacy carrier business model is broken” and that all airlines must shift to a point-to-point, low fare – high frequency model. This is simply not the case – and if it were it would have dire consequences for the vast array of communities in the United States that depend on the mature network carriers for their air service. In order to maintain the broad air service this nation requires to drive its economy forward, there is inarguably a need for both network system air service that can bring together less sense markets in an economical and effective manner, and point-to-point air service. The industry is adapting to both approaches and to hybrid models in between.

In presenting an overview of the financial state of the U.S. airline industry, this Statement will address the central role of the industry in our nation’s economy, the

impact of September 11, 2001 and subsequent world events, the current state of the financial health of the industry, the significant role the Government plays in affecting the health of the industry, and challenges the industry will face going forward. It is also bears emphasis here that this Statement encompasses the impact of September 11th and subsequent world events on both large and small airlines, “legacy” and new entrant, network and point-to-point, all of whom are ATA members. Our members are united by the impacts that these events have had on their businesses, and they stand together on the policy views and recommendations articulated here.

AIR TRANSPORTATION IS CRITICAL TO THE U.S. ECONOMY AND THE COMMERCE OF THE UNITED STATES

In a very broad sense, air transportation functions as a catalyst for economic growth by integrating the world economy and promoting the exchange of people, products, investments and ideas. More directly, there are a number of industries that rely on air travel for their very existence, such as travel and tourism, and aircraft manufacturing. These industries can be grouped into two categories; those that rely on the air transport industry directly for income, and those that rely on the industry to induce consumption. All told, the total direct, indirect and induced impact of commercial aviation exceeded \$800 billion and 10 million jobs in 2000, representing eight percent of the U.S. gross domestic product.

Commercial Aviation Facilitates Economic Growth

GDP Contribution ~ \$800B (8%) in 2000

<u>Component</u>	GROSS DOMESTIC PRODUCT*		
	<u>Impact</u> <u>(\$Billions)</u>	<u>Implicit</u> <u>Multiplier</u>	<u>Share</u> <u>(%)</u>
The Industry (Direct)	306.4	—	3.1
The Source Chain (Indirect)	224.7	1.7	2.3
The Income Impact (Induced)	<u>270.9</u>	1.5	2.7
TOTAL GDP IMPACT	802.0	2.6	8.1

*U.S. GDP in CY2000 was \$9.9 trillion.

Source: Global Insight (formerly DRI•WEFA), *The National Economic Impact of Civil Aviation* (July 2002)

Due to the extensive impact that aviation has on other industries, instability in the industry has a ripple effect that can be debilitating to the U.S. economy, as we saw during the most recent economic downturn. Almost half of the jobs lost in the U.S. economy between September 2001 and November 2002 were related in some way to the air transportation industry. Aside from the direct loss of jobs in the industry, suppliers to airlines were hurt by dramatically scaled down operating budgets and capital expenditures, while travel and tourism industries were hurt by reduced passenger volumes. A failure to adjust those policies within the control of the Federal government that are continuing to sap industry resources will be a drag on the budding recovery for the U.S. economy and threatens further systemic harm.

Aviation/Travel Doldrums Ripple Across the Economy

Half of Post-9/11 U.S. Job Loss is Aviation/Travel-Related

<u>Sector</u>	JOBS (000)			
	<u>Sep-01</u> *	<u>Nov-02</u>	<u>Loss</u>	<u>%</u>
Aircraft and Parts	463	390	(73)	16
Transportation by Air	1,268	1,152	(116)	9
Transportation Services	462	421	(41)	9
Amusement and Recreation Services	1,700	1,635	(65)	4
Hotels and Other Lodging Places	1,852	1,790	(62)	3
Eating and Drinking Places	<u>8,232</u>	<u>8,127</u>	<u>(105)</u>	1
Total Aviation/Travel Related	13,977	13,515	(462)	3
Total Nonfarm	131,819	130,875	(944)	1

*Does not reflect cuts made post-9/11, as surveys predated the terrorist attacks

Source: U.S. Bureau of Labor Statistics

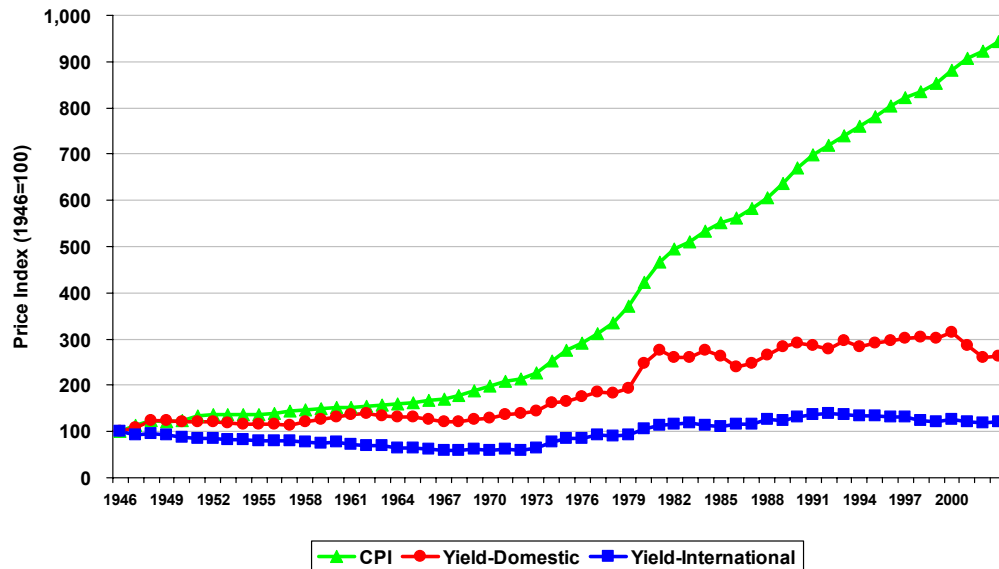
SEPTEMBER 11TH AND SUBSEQUENT EVENTS FUNDAMENTALLY ALTERED INDUSTRY DYNAMICS

There is no doubt that the goals Congress identified for airline deregulation have come to fruition. The number of passengers flying and value of goods shipped by air has grown dramatically and the industry is fiercely competitive. Competition has led to a variety of innovative services and fares, and new airlines have successfully entered the marketplace and prospered. More recently, small communities have seen a dramatic expansion in the availability of jet service and seamless linkages evolve to all parts of the globe. From 1978 through 2001, the number of passenger boardings grew from slightly over 300 million to over 600 million annually. U.S. business also shipped more by air – from 1978 to 2001, air freight ton miles grew from 6 million to over 20 million annually.

Airline ticket prices have fallen 49.8 percent in real terms (adjusted for inflation) since 1978. Obviously, consumers have benefited greatly.

Airfares Have Not Kept Pace With U.S. Inflation

Even Adjusting for Increasing Trip Length, Yields Have Fallen Flat



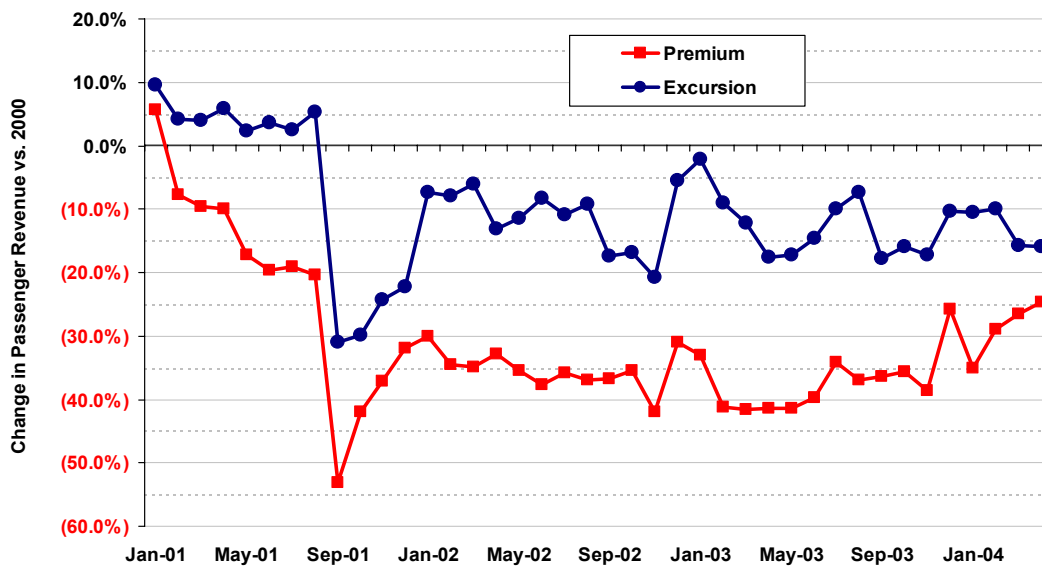
Sources: US Department of Transportation Form 41, US Bureau of Labor Statistics

In the period leading up to September 11th, airline business cycles typically mirrored the broader economy, and market forces worked in the normal course to pick winners and losers. Airlines that could not make the transition to the deregulated economic environment either failed or were absorbed by other airlines. The list includes many airlines with long histories such as Pan American, Eastern, National, Republic, TWA and Western, as well as new entrants such as Kiwi, Air Florida, Legend, Vanguard and Western Pacific. Over the last two decades, Southwest honed a business model since followed (in various ways) by other new-entrant airlines, including America West, JetBlue, AirTran, and Frontier as examples of new consumer services.

Post-September 11th Economic Changes. While the advent of Internet fares, new communication technologies and the bursting of the dot-com bubble were transforming the marketplace pre-9/11, the events of September 11th fundamentally altered traditional industry economic dynamics and passenger travel patterns in several ways. Once air service was restored, demand dropped precipitously, well beyond normal market conditions. In particular, business travel failed to return to previous levels. The airlines experienced an unprecedented drop in revenue that continues today.

Traditional “Business” Revenue Continues to Lag Peak

Estimated Change in Passenger Revenue by Product vs. 2000



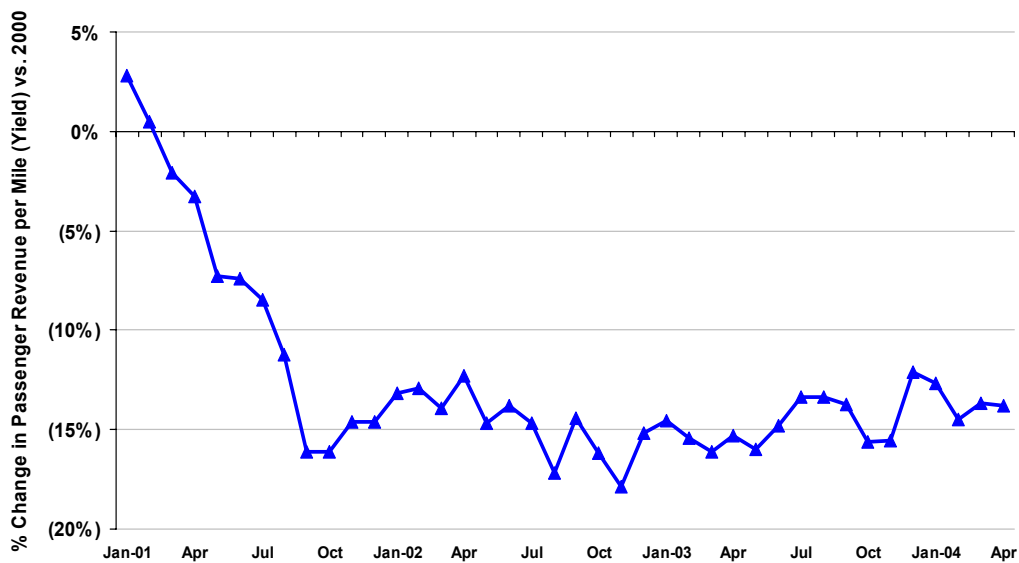
Source: ATA estimates

In response to persistent weak demand, airlines were forced to drop fares in order to stimulate demand, further exacerbating the revenue situation. On average, passenger yield in 2003 was 11.74 cents per mile, 13 percent less than in 2000, and the lowest in nominal terms since 1987. This situation, combined with the more recent growth in low cost carriers and real-time availability of fare information on the Internet, has led to a

dramatic shift in customer purchasing habits. Passengers expect low fares, and air transportation has become much more of a commodity with price being the key driver. Gradually improving loads have not translated into broad price increases.

Pricing Power Remains Elusive

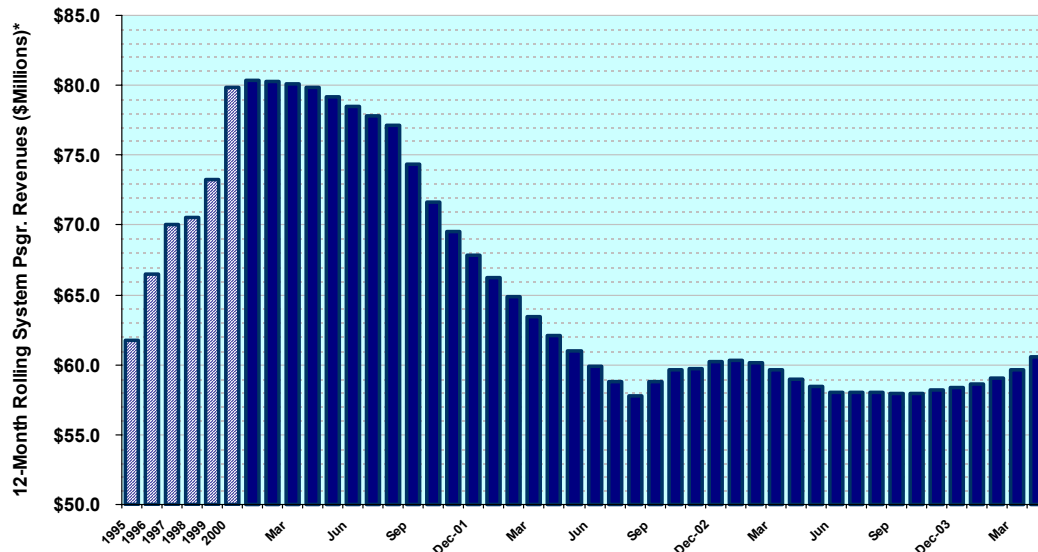
Passenger Yields Down Sharply From 2000*



Source: ATA research

Passenger Revs. Running Below 1995 Levels*

\$20B/yr. (~25%) Gone, Diverted, or Funneled to Commuters



* For mainline operations only; does not include traffic flown on regional affiliates

Source: ATA research

Post-September 11th Security Changes. Another fundamental post-9/11 change was Congress' determination that aviation security should be federalized, thereby inserting the Federal Government into the day-to-day business of air transportation in a way never seen before. In passing the Aviation and Transportation Security Act (ATSA), Congress determined that aviation security is a component of national security and made the Transportation Security Administration (TSA) an instant partner in the business of passenger and cargo air transportation. Checkpoint and checked baggage screening under exclusive Federal control has become the most visible manifestation of this new security paradigm and a fundamental element of the travel experience. Clearly, the quality of that experience has a direct bearing on the public's willingness to fly.

SARS and the War in Iraq. Unfortunately, September 11th was not the only extraordinary exogenous shock to hit the industry. Even as the industry was undertaking drastic measures to adjust capacity to match post-9/11 depressed demand, it was confronted first by the SARS epidemic and then by the War in Iraq in 2003. As ATA noted in *Airlines in Crisis: The Perfect Economic Storm*, this set of circumstances did not result from normal market forces. They were events well beyond the control of the airlines.

While cost-cutting and the other self-help steps undertaken by the industry normally could have been expected to restore profitability, this could not occur. Despite dramatic adjustments by the airlines and Government intervention with the Emergency Wartime Supplemental Appropriations Act (P.L. 108-11), the combined effects of 9/11, SARS and war, when combined with the introduction of new taxes, fees and expenses, have continued to take a toll on the industry.

The Terrorist Threat and New Taxes, Costs and Regulation. The new reality is that the threat of terrorism against the United States remains high. This point was hit home just last week with the Department of Justice's warning that it has evidence that al Qaeda appears to be planning a major attack in the United States this summer. Beyond new security taxes and fees, this constant threat has translated into an ever-growing set of *new* security mandates imposed on the airlines directly, many of which are unfunded and must be paid for directly by the carrier, while others cause airlines to forego significant revenue. New mandates include maintaining "watch lists;" employing staff to verify documents at checkpoints and monitor exit lanes; conducting employee background checks; enhanced security training; modifying aircraft cabins; cargo screening on

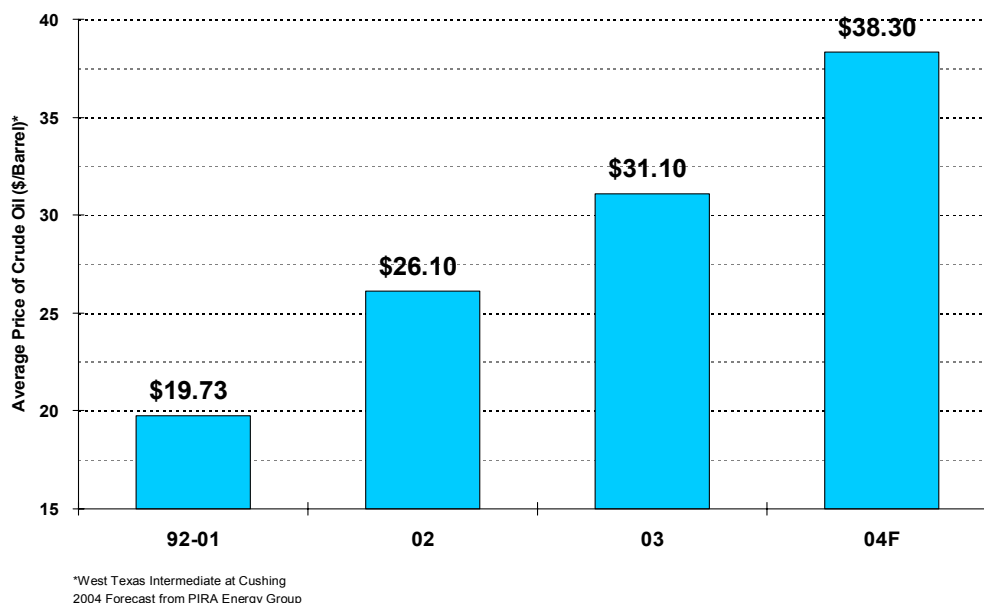
passenger airplanes; screening of private charter passengers and baggage; screening catering supplies; ramp/airplane/airfield security procedures; and crew manifest security procedures, to name just a few.

In addition, U.S. airports pass on to airlines their unreimbursed security costs in the form of higher landing fees and terminal charges, and foreign governments impose still more security fees and costs on the industry. All of these screening requirements, security procedures and training requirements impose significant out-of-pocket costs today, and new requirements/costs are expected as the TSA security regime evolves and adapts to new threats. Until Congress begins treating aviation security as the national defense priority it is, and funds all aspects of aviation security accordingly, we will continue to see the industry and the nation's economy adversely impacted.

Skyrocketing Fuel Prices. Finally, the dramatic rise in the price of oil over the past two years, a byproduct of post-9/11 world tensions, has led to tremendous and devastating increases in jet fuel prices. In 2003, the average price of a barrel of oil was approximately \$31, a significant rise over the average 2002 price of \$26 per barrel. We now expect the average in 2004 to exceed \$38 a barrel, with the price at present hovering around \$40 a barrel. ***The expected \$7 increase from 2003 to 2004 amounts to \$3 billion in additional expense to the industry, on top of an unprecedented and expanding national security/aviation security burden!*** All indications are that these fuel prices will be with us for the foreseeable future.

Post-2001 Fuel Prices Soaring to Record Highs

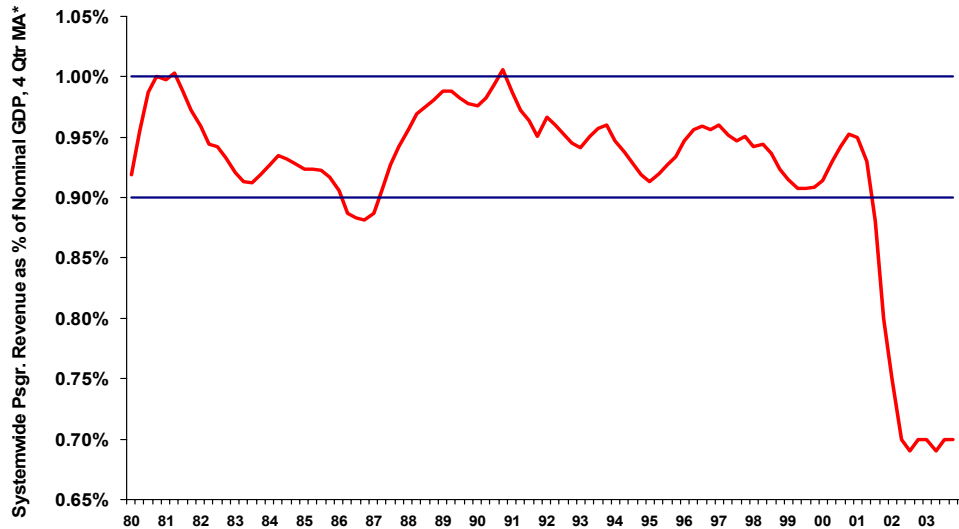
Crude Oil Market Price Hovering Near \$40/barrel



When viewed from where we stand today, it is clear that the airline industry has changed fundamentally – a change that clearly cannot be attributed solely to the normal ebb and flow of market forces. This should be obvious even with the most rudimentary analysis – between security-related costs and the current spike in fuel prices, close to \$7 billion in expense has been added to an industry that has historically survived on razor-thin margins and generated just \$77 billion in passenger revenue in 2003. Indeed, evidence demonstrates an unexpected disconnect from traditional cyclical factors. This is exemplified by the fact that systemwide passenger revenue as a percent of GDP, which traditionally has mirrored broad economic cycles, has dropped dramatically in the post-9/11 environment and shows no sign of recovering. Fundamental economic changes have occurred.

Evidence Suggests Disconnect from Cyclical Factors

Historically > 0.90% of GDP, Passenger Revenue Now Below 0.70%



Source: U.S. Bureau of Economic Analysis and DOT Form 41

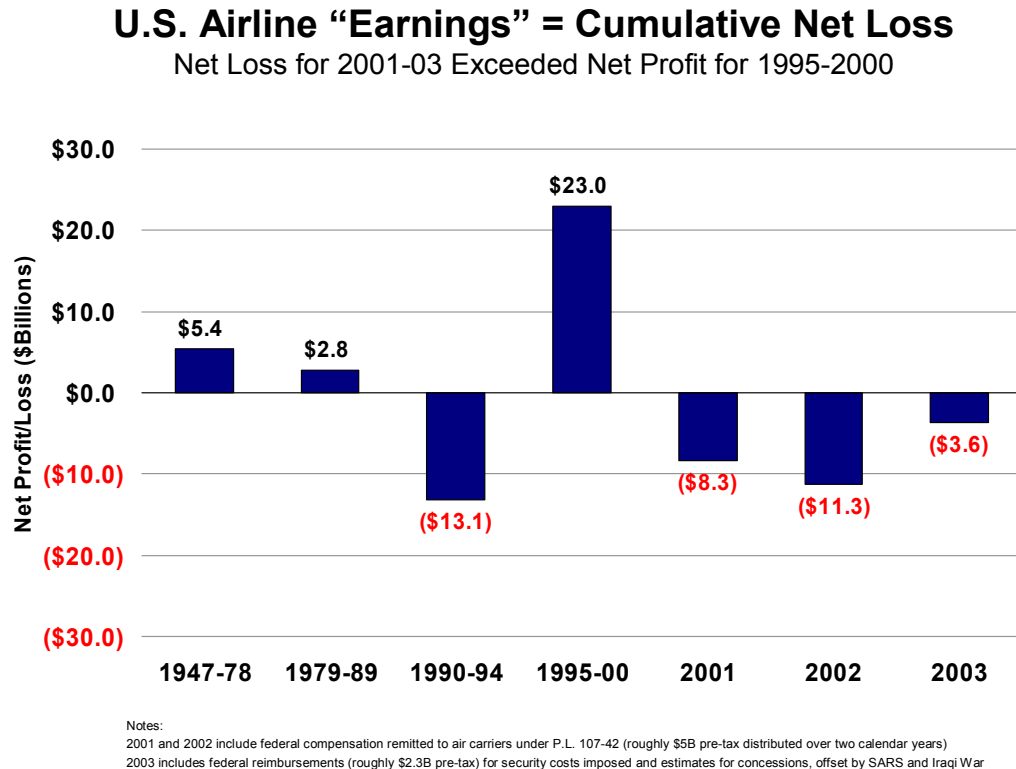
*Passenger revenues from DOT Form 41, majors and nationals.

The unfortunate result of the fundamental changes discussed above is that the industry remains in critical condition. The economic condition of the industry is discussed in more detail in the next section. In the sections following, we will explain the critical impact that Government policies are having on the future viability of this industry.

THE FINANCIAL CONDITION OF THE U.S. AIRLINE INDUSTRY REMAINS CRITICAL

As noted above, in the three years 2001 through 2003, the U.S. airline industry as a whole lost \$23.2 billion. This exceeds the total profit earned in the industry's six best years of 1995-2000. These losses can be attributed largely, though not entirely, to extraordinary events, conditions and new regulatory burdens not associated with normal

market forces. As a result of sustained high fuel prices and growing security obligations imposed on the industry, we expect an industry loss in excess of \$3 billion in 2004, the year that was expected to break even. Whether profitability will return in 2005 remains uncertain, at best.



The impact of these losses has been felt in many ways: airlines have taken on massive debt – in the range of \$100 billion – in order to continue operating. The market cap for passenger airlines stands at an anemic \$21.2 billion, and 11 of the 12 major airlines have junk bond corporate credit ratings. Just last week Delta Air Lines announced it retained both financial and legal counsel for advice on restructuring its business.

Balance Sheets In Disrepair With Heavy Losses

Only Southwest Considered Investment Grade; Others Junk Bonds (incl. Default)

S&P CORPORATE CREDIT RATINGS

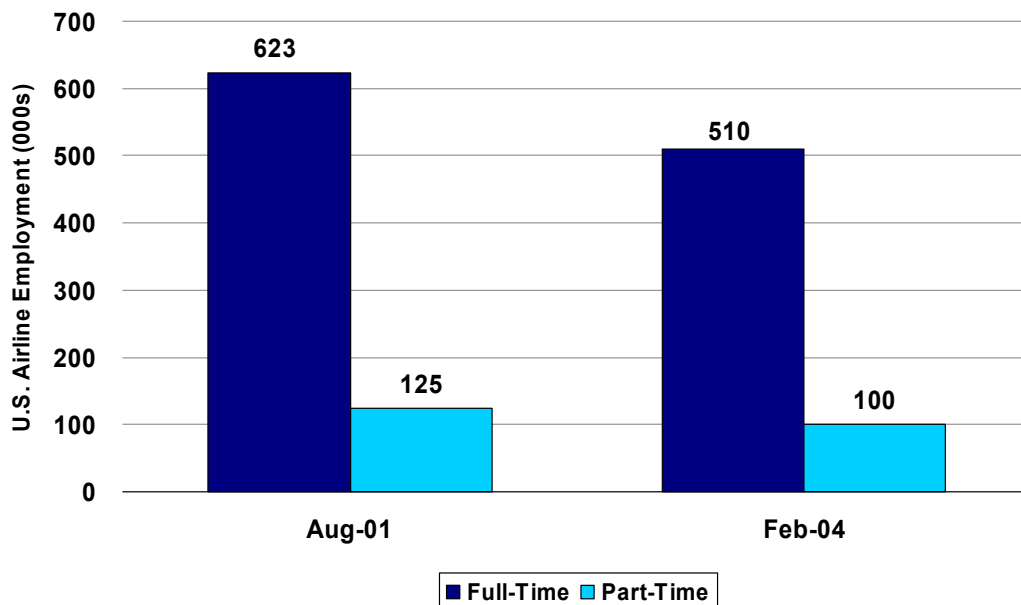
	9/10/01	3/31/03		6/1/04	
	<u>Rating</u>	<u>Rating</u>	<u>Chg.</u>	<u>Rating</u>	<u>Chg.</u>
AirTran	B	B-	(1)	B-	—
Alaska	BB+	BB	(1)	BB-	(1)
America West	B+	B-	(2)	B-	—
American	BBB-	CCC	(8)	B-	+2
ATA	B+	B-	(2)	CCC	(2)
Continental	BB	B	(3)	B	—
Delta	BBB-	BB-	(3)	B-	(3)
JetBlue	n/a	n/a	n/a	BB-	—
Northwest	BB	B+	(2)	B+	—
Southwest	A	A	—	A	—
United	BB+	D	(9)	D	—
US Airways	B	D	(8)	CCC+	+3

Note: > BBB- = investment grade; < BBB- = junk bond status

The negative repercussions of world events have been felt in much more personal ways. Airlines furloughed employees, negotiated for productivity improvements, and pared back benefits to employees and retirees. According to DOT, as of February 2004 airline headcount was down 138,000 from August 2001, meaning that one in five industry jobs have been lost. Recent announcements by some airlines suggest that additional furloughs may yet be required, largely due to the sustained high price of fuel.

Airline Headcount Down ~ 138,000 Post-9/11

Reduction in Demand and Quest for Productivity Fueling Furloughs



Source: DOT Employment Report (P1a) and carrier reports

The industry has been very proactive in initiating cost cutting in an effort to cope with the new environment. Overall operating expenses were cut 13 percent from 2001 to 2003, a difference of over \$12 billion. On the labor front, carriers have achieved expense reductions by not only by reducing headcounts, but also by restructuring the contracts of remaining employees -- for wages and benefits, and by eliminating many anachronistic work rules. These measures, along with operational improvements and technological investments, have helped labor productivity climb 11 percent in 2003 to 2.1 million Available Seat Miles per employee, the highest productivity on record. Fuel efficiency also hit an all-time high in 2003, growing 5 percent to 43.6 passenger miles per gallon, thanks to aggressive fuel conservation measures. No single expense has escaped the

watchful eye of airline management, as carriers have deferred aircraft orders, reduced passenger food costs, parked aircraft, simplified fleet plans, and cut booking fees, to name a few initiatives.

These extensive changes are quantified on the following chart comparing self-help initiatives, and show that cutting continued in 2003 even after substantial measures were taken in 2001-02. These ongoing efforts are perhaps best typified by recent announcements by both legacy and low-cost carriers of impending job cuts or large-scale employee buy-out offers to combat rising fuel prices and other costs.

U.S. Airline Self-Help Initiatives

Numerical Summary of Key Metrics for ATA Passenger Airlines*

<u>Component</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>	2003 vs. 2001*	
				#	%
Operating Expenses (\$-Billions)	86.4	92.6	98.8	(12.4)	(13)
Legacy	73.0	79.8	86.4	(13.4)	(16)
Other	13.4	12.7	12.4	1.0	+8
Capital Spending (\$-Billions)	5.1	6.8	13.3	(8.2)	(62)
Legacy	2.8	5.2	10.9	(8.1)	(74)
Other	2.4	1.5	2.5	(0.1)	(4)
Seating Capacity (Billion ASMs)	829.4	851.4	883.2	(53.8)	(6)
Legacy	661.3	698.6	742.0	(80.7)	(11)
Other	168.1	152.8	141.2	26.9	+19
Operating Fleet (Mainline)	3,671	3,835	3,894	(223)	(6)
Legacy	2,860	3,049	3,146	(286)	(9)
Other	811	786	748	63	+8
Employment (000 FTEs)	380.9	426.0	477.2	(96.3)	(20)
Legacy	309.8	356.1	409.8	(99.9)	(24)
Other	71.0	69.9	67.4	3.6	+5

*SEC filings of Alaska, America West, AMR, ATA, Continental, Delta, Hawaiian, JetBlue, Midwest, NWA, Southwest, UAL, and US Airways

But these efforts, combined with price cutting and other efforts to stimulate traffic, have not proven enough to overcome the sweeping industry changes. In particular, it is apparent that consumer pricing expectations have undergone fundamental

change. Consumers have come to expect extraordinarily low prices. Consequently, even though planes are often full, customer price sensitivity is such that airlines are unable to raise fares to achieve profitability in today's cost environment. Fare changes and corresponding traffic changes at Washington Reagan National Airport, summarized below, illustrate the airlines' inability to raise prices.

Washington Reagan National (DCA) Markets

Domestic Local (O&D) Traffic, 2003 vs. 1996

<u>Markets Where Average Fares:</u>	<u># of Markets</u>	<u>Fare Change</u>	<u>Traffic Change</u>
Increased	163	17%	(22%)
Remained Flat	7	0%	(12%)
Decreased	303	(12%)	1%
Total	473	(2%)	(8%)

Source: US Department of Transportation Origin and Destination Survey

This point is further illustrated by the chart below, which summarizes recent attempts by individual airlines to increase prices. The airlines have attempted ten non-fuel surcharge price increases in 2004. Most failed, a few held, and two had partial success.

Domestic System Fare Increases: Jan-Apr 2004

<u>Effective Date</u>	<u>Initiating Carrier</u>	<u>Increase Result</u>	<u>Comments</u>
1/16/04	Delta	Failed	Most Fares
1/22/04	AirTran	Stuck	Most Fares
1/30/04	Delta	Failed	Most Fares
2/5/04	United	Failed	Leisure Fares
2/18/04	AirTran	Stuck	Non-ATL Markets
2/26/04	Continental	Failed	Most Fares
3/3/04	ATA	Stuck	Most Fares
3/4/04	Delta	Failed	Most Fares
3/18/04	Delta	Partial	Leisure Fares
4/22/04	Northwest	Partial	Most Fares

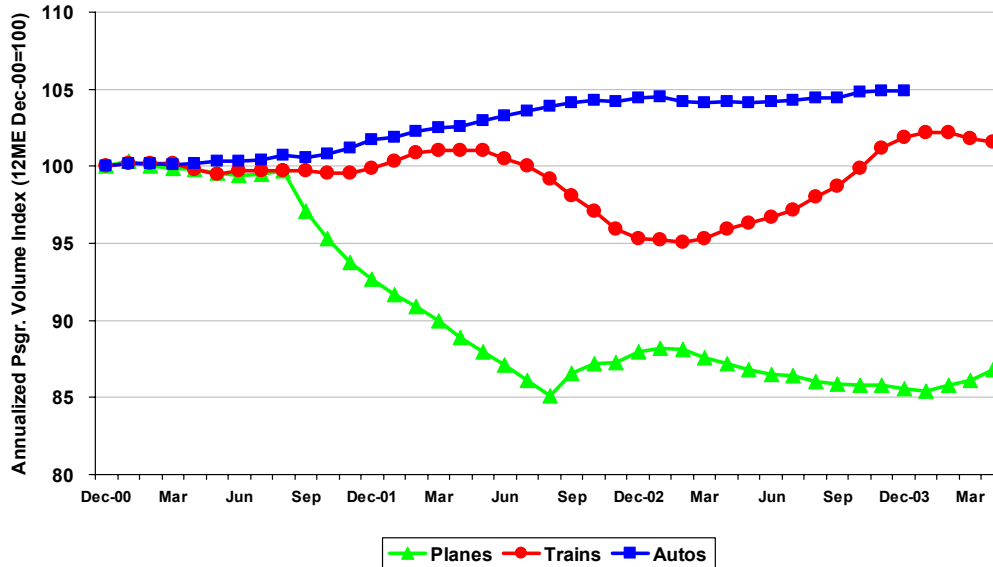
Source: US Airways

Even attempts to impose fuel surcharges in response to the devastating increase in fuel prices have had only limited success. In a recent example, which received considerable media attention, Continental was forced to abandon its May 18, 2004, attempt because competitors did not match. Similarly, last week United rescinded an attempt to increase in its fuel surcharge. This record answers more eloquently than anything else those who argue that taxes, fees and other expenses can simply be “passed on” to the consumer. Were that the case, airlines would never lose money – let alone suffer the financial condition they find themselves in today.

Customer price sensitivity is fueled not only by the competitive environment in which the industry operates. Airlines also compete with other transportation modes, and since September 11th it is clear that more people are choosing to drive where in the past they would have flown.

Planes, Trains & Automobiles . . .

Cars the Clear Winner; Up Consistently Since 9/11



Sources: ATA (Domestic Enplanements); Amtrak (Revenue Passenger Miles); Census Bureau and Federal Highway Administration (Rural Arterial Vehicle Miles); Travel Industry Association

The immediate availability of fully transparent price information on the Internet through multiple, competing sources also has contributed to the change in consumer purchasing habits. Consumer purchases have shifted dramatically from paper tickets obtained through travel agencies or airline ticket offices to Internet purchases. Accompanying this change in distribution change has been an immeasurable increase in consumer knowledge. Consumers can now “comparison shop” in real time. This has introduced even more competitiveness to pricing and marketing in the U.S. airline industry – perhaps to a greater extent than that experienced by any other industry. The consumer has been the clear beneficiary.

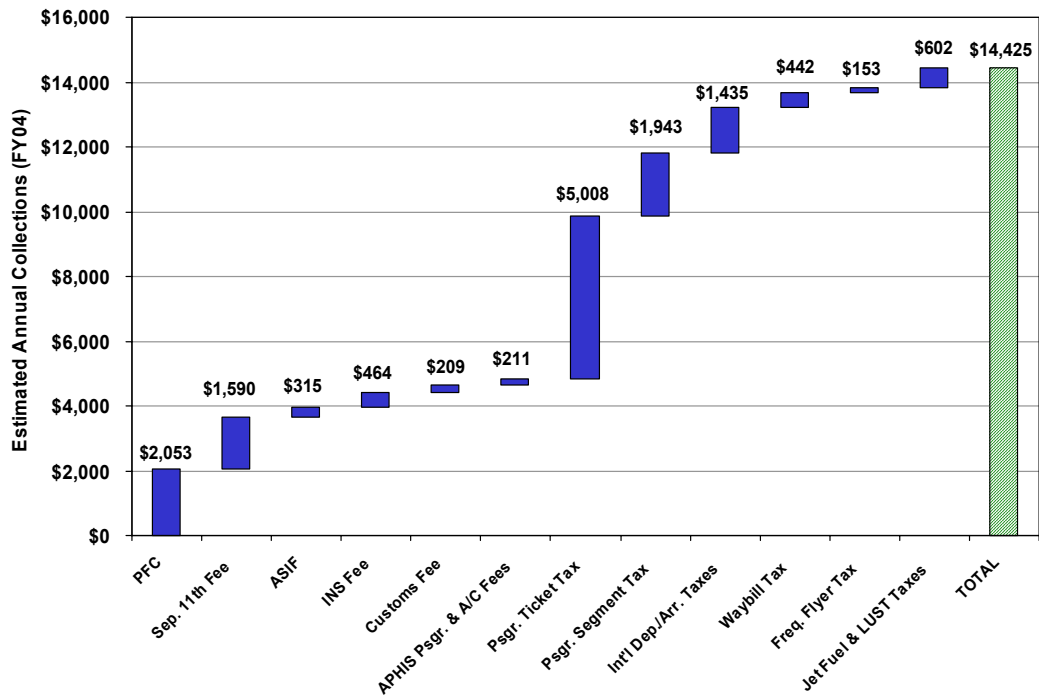
THE IMPACT OF FEDERAL TAX/FEE POLICIES

The Industry Tax Burden. Airlines operating in, to and from the U.S. face a crushing special tax and fee burden that is estimated to exceed \$14 billion in FY2004. This tax burden distorts the normal functioning of market forces and fundamentally depresses the industry. Nonetheless, the Government's appetite for taxing the industry has been unyielding. Since 1988, the average tax on a \$200 domestic round-trip ticket has increased 250 percent, while average domestic yields have actually declined 3 percent. This is so despite the 1993 recommendation, made by the National Commission to Ensure a Strong Competitive Airline Industry, to relieve the industry of its "unfair tax burden."²

² "Tax policies often have had a major and adverse effect on the industry. Although the Commission concluded that tax changes alone will not restore the industry to profitability, we believe there are several tax provisions that impede the ability of the industry to return to financial health. We believe those provisions violate reasonable principles of common sense and good public policy and we are of the opinion changes must be made to relieve the airline industry's unfair tax burden." *Change, Challenge and Competition: A Report to the President and Congress* (August 1993), The National Commission to Ensure a Strong Competitive Airline Industry.

U.S.-Based Aviation Taxes and Fees

Over \$14 Billion Estimated for FY2004*

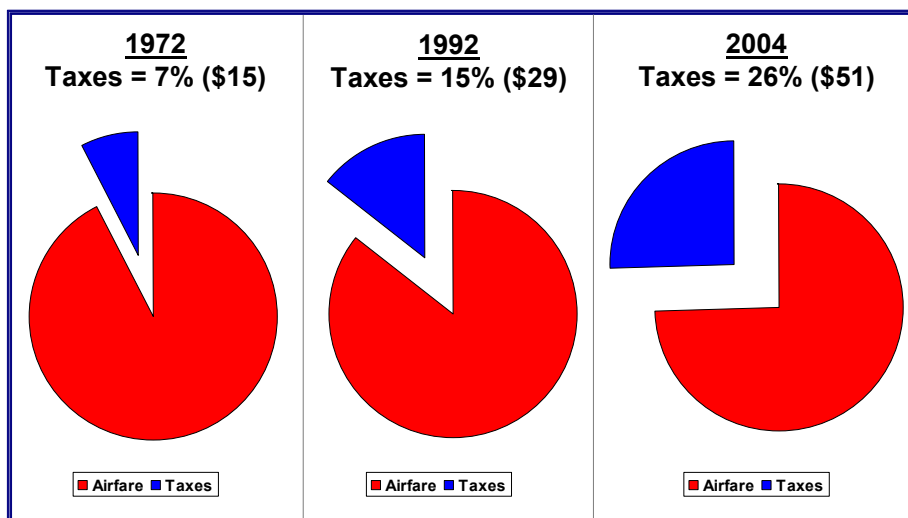


* Some taxes and fees shown include collections from non-U.S. carriers.

The past few years have been particularly hard on the industry. Since 1992, taxes on a \$200 domestic roundtrip ticket have risen by \$22, placing downward pressure on what the airlines themselves can charge.

Uncle Sam Taking a Bigger Bite

Once a Small Fraction, Federal Taxes/Fees Now a Fourth of Sample Ticket*



* Itinerary assumes a single-connection domestic roundtrip with maximum passenger facility charge (PFC) at each airport; \$200 total price includes taxes and fees.

Aviation taxes have outpaced inflation and fares, and air transportation is taxed at a higher rate than the consumption of beer and liquor, luxury vehicles, telephone service, and most notably, bus and rail transportation, which face no federal travel tax.

Federal Consumption Taxes & Fees High on Flyers*

Uncle Sam Taxes Low-Priced Air Travel Above Sins, Luxuries, and Other Modes

Product	%	Product	%
Plane Ticket: One-Stop (\$100) ¹	44.2	Heavy Firearms / Ammunition	11.0
Plane Ticket: Non-Stop (\$100) ¹	25.6	Distilled Spirits (\$20) ⁴	10.7
Plane Ticket: One-Stop (\$200) ¹	25.6	Sport Fishing Equipment	10.0
Plane Ticket: One-Stop (\$300) ¹	19.4	Pistol or Revolver	10.0
Pack of Cigarettes (\$4.50) ²	18.2	Can of Beer (\$1.00) ⁵	5.0
Plane Ticket: Non-Stop (\$200) ¹	16.3	Luxury Vehicle (Portion > \$40K)	3.0
Plane Ticket: Non-Stop (\$300) ¹	13.2	Telephone Service	3.0
Arrow Components	12.4	Elec. Outboard Motors / Sonar ⁶	3.0
Heavy Truck / Trailer / Tractor	12.0	Ship Ticket (\$1,000) ⁷	0.3
Gallon of Gasoline (\$1.60) ³	11.5	Bus Ticket	0.0
Bows	11.0	Rail Ticket	0.0

¹ Roundtrip with federally approved \$4.50 PFC

² Taxed at 82¢ per pack

³ Taxed at 18.4¢ per gallon

⁴ Taxed at \$2.14 per 750-milliliter bottle

⁵ Taxed at 5¢ per can

⁶ Up to a maximum of \$30.00

⁷ Taxed at \$3.00 per ticket

Note: The federal government also taxes the sale of tires over 40 pounds, coal, wine, vaccines, foreign-issued insurance, and selected other items.

*Analysis considers federal taxes and fees only; does not examine the broader impact of state and local taxes, which can be especially high on alcohol and tobacco.

Sources: ATA research; Internal Revenue Service; Bureau of Alcohol, Tobacco & Firearms

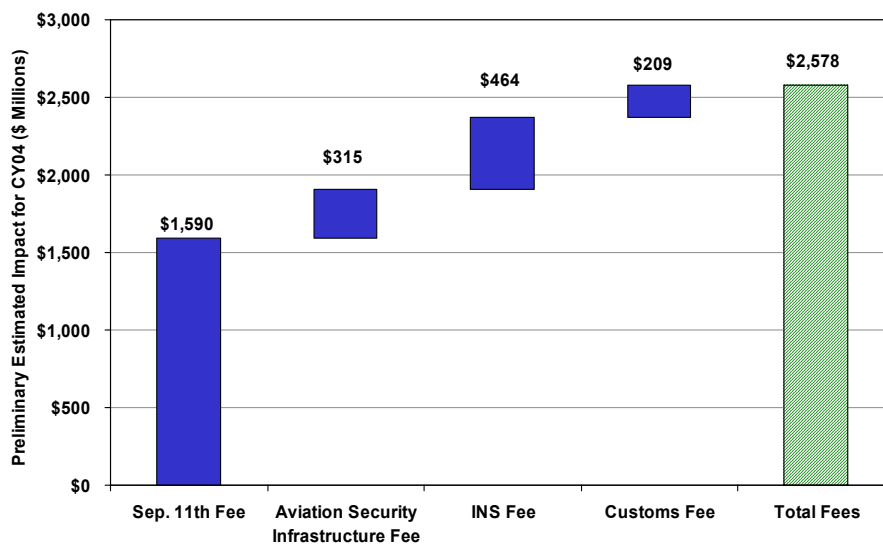
Security Taxes, Fees & Expenses Grow Unabated.

The burden of security taxes, fees and costs, in particular, deserves close scrutiny. As the following set of charts illustrate, the post-9/11 mandates impose costs on the industry, both direct and indirect, that now total an estimated \$3.8 billion annually. This includes \$2.578 billion in various homeland security fees, \$518 million in forgone revenue due to security mandates, and an additional \$739 million in direct security expenses imposed on the carriers.

And these fees and costs are not static. As passenger volumes grow, the September 11th fee will grow. The TSA estimates that the September 11th fee will produce \$1.83 billion in FY2005. Similarly, foregone revenue will increase as capacity is expanded to match demand and new unfunded security requirements are imposed on the industry.

Pretax Financial Impact of Federal Security Mandates

HOMELAND SECURITY FEES: PRELIMINARY CY04 Projections (6/1/04)

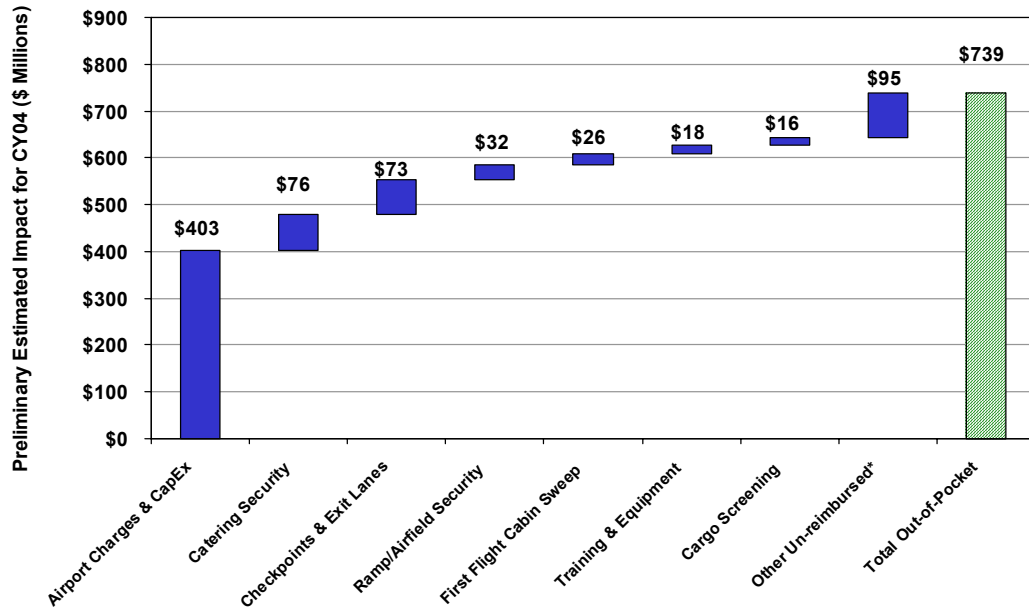


NOTE: Previous surveys included war risk insurance, but did not include all DHS fees.

Source: ATA

Pretax Financial Impact of Federal Security Mandates

OUT-OF-POCKET MANDATES: PRELIMINARY CY04 Projections (6/1/04)



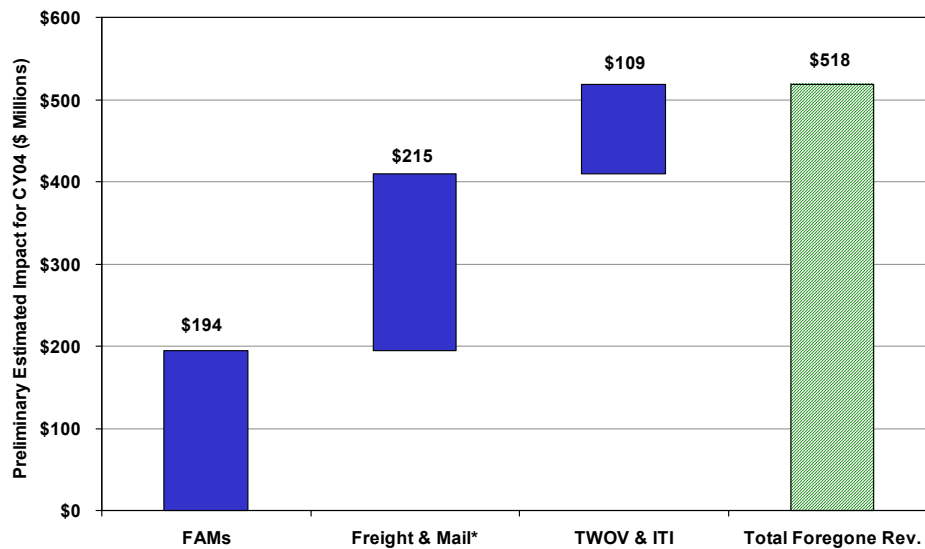
NOTE: Previous surveys included war risk insurance, but did not include all DHS fees.

*Maintenance of selectee/no-fly lists and resultant procedures), screening of pax/property on private charters, non-U.S. security fees, int'l crew manifest list maintenance and submission, other.

Source: ATA

Pretax Financial Impact of Federal Security Mandates

FOREGONE REVENUE: PRELIMINARY CY04 Projections (6/1/04)



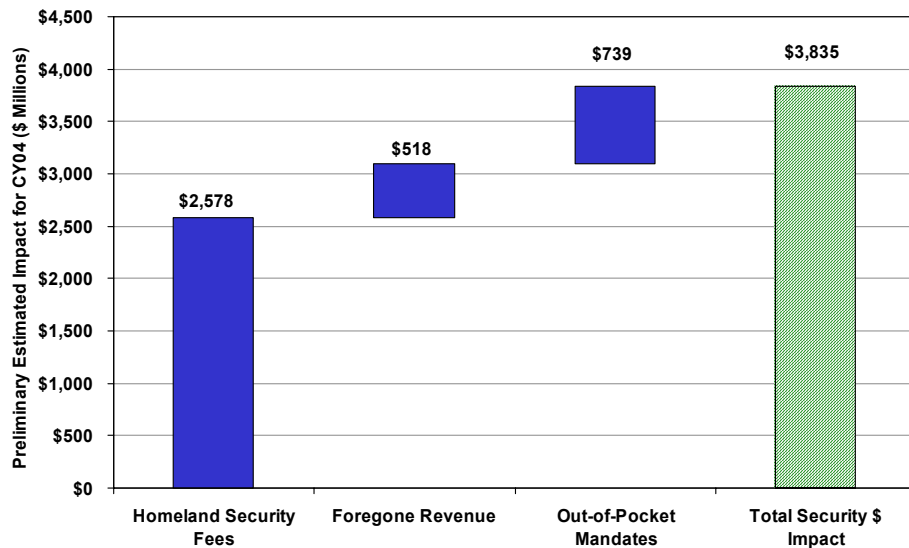
NOTE: Previous surveys included war risk insurance, but did not include all DHS fees.

*Quantification of "Known Shipper" rule and prohibition against carriage of priority (> 16 oz.) mail on flights engaged in passenger transportation

Source: ATA

Pretax Financial Impact of Federal Security Mandates

TOTAL: PRELIMINARY CY04 Projections (6/1/04)



NOTE: Previous surveys included war risk insurance, but did not include all DHS fees.

*Airport charges and capital modifications, screening of catering supplies and materials, checkpoint document verifiers, exit lane monitors, ramp and airfield security, first departure of the day cabin sweep, training and equipment, cargo screening, other un-reimbursed.

Source: ATA

As one former senior Administration official has observed,

September 11 necessarily increased the number of unfunded mandates on air travel. Obviously security is a prime concern. But unfunded mandates allow politicians to claim credit without facing the costs. Meanwhile, many business travelers who require speed and convenience have been forced off the airlines and onto corporate jets, depriving the carriers of some of their highest-margin customers...Any industry requires sensible regulatory and tax policies to survive. Setting up a workable regulatory and tax framework for the nation's airlines should be a top priority. The status quo won't fly.³

It is stating the obvious to note that the aggregate impact of these fees, costs and charges has contributed significantly to the mounting industry losses over the past three years. There is, of course, no conclusion but that the out-of-pocket mandates and foregone revenue items have a direct impact on the carriers' bottom line. It has, however, been argued by some that passenger fees, such as the \$1.6-1.8 billion September 11th Fee, have

³ Lawrence B. Lindsey, *The Status Quo Won't Fly*, Wall Street Journal (April 1, 2003).

no similar impact. As Congress recognized last year, however, this is not the case. As part of the Iraq War Supplemental Appropriation, Congress both noted and acted upon the correlation between user fees and what the airlines are able to charge for their product. In a commodity business like air transportation, the more the government collects for air travel, the less the airlines are able to charge. This fundamental economic principle⁴ was validated when Congress suspended the September 11th Fee for four months and industry returns reflected that economic benefit.

New security-related costs and foregone revenue are on the horizon. TSA is expected to issue a new set of cargo security regulations in the very near future. Implementing these new requirements will add further to the industry cost burden. TSA is also working on the CAPPS II program. Implementing that program will also add to the industry cost burden, requiring programming and computer system changes, employee training and substantially increased time that reservation agents must spend to collect additional passenger data.

In addition, several DHS programs under way will have significant operational and cost impacts on U.S. airlines. These include its Advance Passenger Information System (APIS), which requires manifest information on passengers arriving in the U.S. to be transmitted prior to their arrival; the related passenger name record (PNR) program that requires certain PNR data to be transmitted prior to arrival; the U.S. Visit program, which when fully functional will track the entry and exit of airline passengers arriving in

⁴ “The statutory incidence of a tax indicates who is legally responsible for the tax...Because prices may change in response to the tax, knowledge of statutory incidence tells us essentially nothing about who is really paying the tax...***The [economic] incidence of a unit tax is independent of whether it is levied on consumers or producers.***...In general, the more elastic the demand curve, the less the tax borne by consumers...The key point to remember is that nothing about the incidence of a tax can be known without information on the relevant behavioral elasticities.” *Public Finance (4th Ed.)*, Harvey S. Rosen (Princeton University Department of Economics)

this country; the crew manifest program that requires crew manifest information to be transmitted prior to arrival; the advance cargo manifest program that requires cargo information to be transmitted prior to arrival; and the known shipper program that imposes certain information requirements on carrier cargo acceptance practices. In addition, in 2003 DHS suspended the Transit Without Visa (TWOV) and International-to-International (ITI) programs, which allowed passengers to transit the U.S. at airport stopover points without formally entering the U.S. for immigration purposes. The suspension of these programs has caused U.S. airlines to lose both revenue and their competitive position for these passengers. The suspension of the TWOV and ITI programs is causing U.S. airlines to lose more than \$100 million annually in revenue.

The Push for MANPADS Counter-technology. Forces in both Congress and the Administration, at the urging of equipment manufacturers, are pushing for the rapid installation of MANPADS (shoulder fired missiles) counter-technology aboard commercial aircraft. While the threat of a MANPADS attack is real and must be assumed and confronted, to an unfortunate degree the study going forward today is not focused on determining the relative degree of threat present in relationship to the array of other threats confronted and the availability of resources to deal with those threats. In short, it is not setting priorities for security spending but rather seems headed in the direction of making the solution fit the threat – without regard to resource limitations. The airlines are gravely concerned that, absent prioritized and targeted spending, this could result in the imposition of still more costs (some estimates exceed \$100 billion over the life of the system) on an industry not able to sustain even existing government mandates and exactions.

Uncertainty About Security Lines Inhibits Air Travel. An additional impact on passenger purchasing decisions, even though difficult to quantify, is the long waits at security checkpoints. . Passenger concerns about security delays and uncertainty deter people from flying, plain and simple. While TSA and the industry work every day to minimize this effect, it remains a major reason why people have substituted cars and other transportation modes for flying, particularly for short-haul trips. The airlines are very concerned about the impact of TSA delays this summer.

TSA predicts that passenger volumes will increase from 58 million to 65 million per month during the summer, a sustained 12 percent increase in monthly volumes over 2003's single peak month. We are already seeing security lines with wait times of 45 minutes and more at major airports, including Washington Dulles, Los Angeles International Airport, Las Vegas McCarran, and Atlanta Hartsfield. The industry is working with TSA to help develop its Summer Plan, and we are doing what we can to educate our customers on what they can do to reduce potential wait times. Also, TSA is hiring additional screeners at some airports. However, these efforts will not fully eliminate the public concern about the hassles of flying. Those concerns, which keep passengers away, will not subside until TSA has determined the number of screeners necessary to efficiently and effectively screen passengers and established processes that can move passengers through security screening in ten minutes or less on a consistent basis nationwide. It is imperative that we continue to see progress toward this goal, and Congress should insist on TSA finalizing its model to predict accurately the number of screeners needed at each airport.

Maintaining Safety Remains A Top Priority. The fact that the industry incurs significant costs on an ongoing basis to comply with FAA safety regulations and to maintain their aircraft is sometimes lost in the debate about security. The fact of the matter is that throughout the past three years, U.S. airlines have maintained an extraordinary safety record notwithstanding the many challenges they have confronted. The FAA, quite appropriately, remains vigilant in its oversight of the industry. For example, in 2003, the FAA issued numerous Advisory Directives (ADs) requiring airlines to take specific maintenance actions on their aircraft. According to the FAA, the cost to U.S. airlines to achieve these ADs exceeded \$900 million. In 2002, that cost exceeded \$1.3 billion. As always, we will continue to make safety our top priority.

GOVERNMENT POLICIES ARE PIVOTAL TO ALLOWING THE INDUSTRY TO RETURN TO PROFITABILITY

Government policy choices can either support or impede the industry's efforts to return to profitability. Taxes, fees, and poorly devised regulations have long been recognized as impositions that distort market forces. Future policy choices by Congress, TSA and the FAA will be pivotal to the industry's ability to achieve profitability.

Given the fragile state of the airline industry, supporting the industry's recovery – or at least not interfering unnecessarily with efforts to achieve stability – should be the foundation of future Government policy decisions. When faced with policy decisions, Congress and the agencies must ask if the proposed action will assist or interfere with the industry's recovery; is there an alternative that will achieve the desired objectives that would have a positive impact on the industry?

This approach can and should be applied to policy issues that will come before Congress in the near future. Chief among these are the proposed \$435 million increase to the Aviation Security Infrastructure Fee (ASIF), and extending the FAA's war-risk insurance program and related terrorist act liability cap.

ASIF. The Administration has proposed a change to the pending DHS appropriations bill⁵ that would raise the amount TSA collects from airlines by \$435 million per year – to \$750 million annually. This represents a tax increase of 138 percent. As noted, this would come on top of the more than \$3.8 billion already incurred by airlines for maintaining national defense. At a time when the industry is struggling to manage these expenses and the impact of a \$3 billion annual spike in fuel costs, it becomes patently obvious that security costs simply must be treated as national defense priorities and be funded accordingly.

War-risk Insurance. Aviation war-risk insurance is indispensable for U.S. airlines. This insurance provides coverage for acts of violence against airlines such as terrorism, hijackings and sabotage. War-risk coverage benefits not only airlines but also persons on the ground and property where such third parties suffer losses that result from acts of violence against an airline. The FAA's mandate for its war-risk insurance program is set to expire in August. The related cap on liability arising from terrorist acts expires at the end of the year.

The commercial market cannot provide war-risk coverage on terms that are reasonable or costs that are bearable for U.S. airlines. Market analysis suggests that

⁵ The appropriations bill would amend ATSA by changing the air carrier fee from the amount paid in calendar year 2000 for passenger and baggage screening to \$750 million. The Subcommittee should not countenance this maneuver to amend ATSA.

carriers could only obtain limited commercial coverage, including a seven-day cancellation clause, at several times current premiums.

Since airlines literally cannot operate without war-risk insurance, a statutory extension of the FAA war-risk insurance program and the related act-of-terrorism liability cap is essential for the U.S. airline industry. Aircraft loan and lease agreements typically require airlines to obtain and maintain such insurance. Moreover, some foreign countries require that airlines have war-risk insurance as a condition to operating in their airspace or at their airports.

U.S. airlines continue to represent the prime aviation target for acts of terrorism; assuring necessary insurance coverage for U.S. airlines therefore is a matter of utmost public policy importance. U.S. airlines are highly visible symbols of American society and our government's policies. The recent terrorist attacks in Madrid are a violent reminder of the willingness of terrorists to target prominent transportation providers. The identification of U.S. airlines with U.S. Government policies is a compelling reason for the FAA to continue to provide war-risk insurance.

A return to the commercial market to obtain war-risk insurance could cost U.S. airlines \$600-\$700 million in premiums annually. This may prove to be a conservative estimate because it assumes that insurers will not assign U.S. airlines a risk premium above the rate being charged to foreign-flag airlines, most of which are regarded as far less likely terrorist targets. Moreover, it does not take into account the anticipated exclusion in commercial aviation policies of attacks involving radioactive (dirty bombs), chemical or biological agents, or electromagnetic pulse devices.

There still is a very real risk that an act of terrorism against an airline, U.S. or foreign-flag, or a significant domestic terrorist act of any kind, could trigger the withdrawal of aviation insurers from the insurance market or their imposition of radical, adverse changes to commercial policies. As noted above, the Department of Justice announced on May 25, 2004 that it has evidence that al Qaeda plans to launch an attack within the United States sometime this summer.⁶ Insurers were quick after 9/11 to invoke the seven-day cancellation provisions. We have no doubt they will do the same again.

The foregoing considerations demonstrate the need to extend the statutory requirement that the FAA provide U.S. airlines aviation war-risk insurance and to extend similarly the act-of-terrorism liability cap. Failure to do so will add yet another extraordinary burden the industry must bear. At best, failure to act will further impede the industry's recovery and cause the airlines to take additional cost-cutting measures, including reducing headcount and cutting capital expenditures. At worst, it could cause further industry contraction.

Agency Actions. Federal agencies also face policy choices critical to the industry. They should approach these choices analytically, with the guiding principle that their actions should support, not hinder, the industry's recovery. FAA, for example, already is beginning to face congestion issues at some airports. The solution, as DOT Under Secretary Shane noted recently, is not to artificially restrict demand by limiting airport access, but to expand the necessary infrastructure to accommodate the demand that is driven by passengers. This situation is a prime example of an issue where the agency is faced with policy choices that can either help or hurt the industry. Here, market forces

⁶ Washington Post, May 26, 2004; New York Times, May 27, 2004.

clearly dictate airline frequency and service patterns. We think the choice is clear, yet “demand management,” as it is euphemistically described, remains popular in certain quarters within FAA and DOT. Artificial “demand management” should not be allowed to shape the U.S. airline industry or the nation’s economy.

Likewise, TSA will be faced in the relatively near future with determining whether to advance MANPADS countermeasures. The response to the MANPADS threat must be a disciplined, analytical approach based on facts and careful analysis that encompasses both security and safety considerations. The MANPADS threat must be placed in context with other threats and analyzed accordingly: *what is the correct priority of the MANPADS threat relative to other security threats, and how can we best use our available resources on the highest priorities?* Not taking on these key questions, in our view, creates the risk that we will see billions of dollars expended (to the satisfaction of those who would do us harm) without any understanding of the totality of risk we are dealing with and the potentially greater security benefits that could be derived from more targeted uses of limited resources. We must be disciplined and not simply throw resources at MANPADS countermeasures because we can.

We are not saying that the ATA member airlines oppose deploying MANPADs countermeasures. *We are saying that there should not be a rush to judgment until all of the facts are in and we fully understand the implications of deploying such countermeasures, including the benefits relative to other security risks we face.* Unfortunately, to a great degree, the work that has been done under the existing DHS MANPADs program has focused on systems issues and not threat analysis. We know we have a MANPADS countermeasures system that works for the military and to all

appearances seem determined to make it work commercially. We seem determined to make the solution fit the problem. In our view, this puts the cart before the horse. We need to recognize that the problem is the threat of terrorism in general and that the solution is to spend as intelligently as we can to eliminate that problem – not just focus reflexively on countering specific risks the problem presents.

CONCLUSION

The U.S. airline industry remains in a precarious economic condition. From 2001 through 2003 it suffered a net loss of \$23.2 billion, plus an additional \$1.6 billion in the first quarter of 2004, with full-year 2004 losses expected to exceed \$3 billion. Since 2000, passenger revenues have declined 18 percent as yields have fallen 13 percent. Even for those few low cost carriers who have managed to eke out a profit, margins are slim, and it is clear that very little is needed to push them into the red. In the post-9/11 era, passengers have come to expect low fares regardless of the airline product, and they continue to prove this point daily through their purchasing behavior.

The industry has responded aggressively to these conditions, including dramatic workforce reductions, modified work rules and benefits for employees and retirees, revised procurement policies and procedures, fleet simplification plans and retiring airplanes, deferred capital expenditures, streamlined and revised distribution channels, and introducing new technologies. Network carriers also have revised scheduling and operating plans to minimize hub operation costs. At this point, other than further workforce reductions or changes to wage scales (to the extent they can even be

negotiated), there is little the industry can do to reduce costs. Furthermore, certain costs cannot be controlled. The run-up in fuel prices has cost the industry close to \$3 billion in 2004 and may not abate sufficiently in 2005.

Accordingly, Government policies will play a critical role in determining whether the industry is able to achieve stability and return to profitability. Government policies should support stability and growth, and permit airlines to attract needed capital. In this regard, the proposed ASIF increase should be rejected, and the FAA's war-risk insurance program should be extended. Further, agencies must exercise their regulatory authority deliberately, and assisting the industry should be a foundation policy. Threats to security and safety must be prioritized based on a careful review of the facts, and solutions must provide a clear and justifiable benefit both on their own merits and relative to other known risks.

Finally, Congress must not waiver from its determination that aviation security is an essential component of national security; however, it must now act consistently with that principle and fully fund aviation security from general tax revenues. After all, the cost to society of an act against aviation far exceeds the cost to the industry and its customers alone. Taxes and fees imposed on the industry, whether on airlines, airports or passengers, ultimately impact the industry's ability to meet consumer demand to grow and produce further economic expansion in all sectors of the economy. The popular justification for imposing such taxes and fees is that passengers are willing to pay is not borne out by the facts. In the fiercely competitive and price-sensitive environment that is the new industry paradigm, airlines are not able to pass through new taxes, fees and costs

– whether for security, fuel or airport development. Congress must act accordingly.

On behalf of our member airlines, thank you for considering these comments.

Air Transport Association of America, Inc.
June 3, 2004